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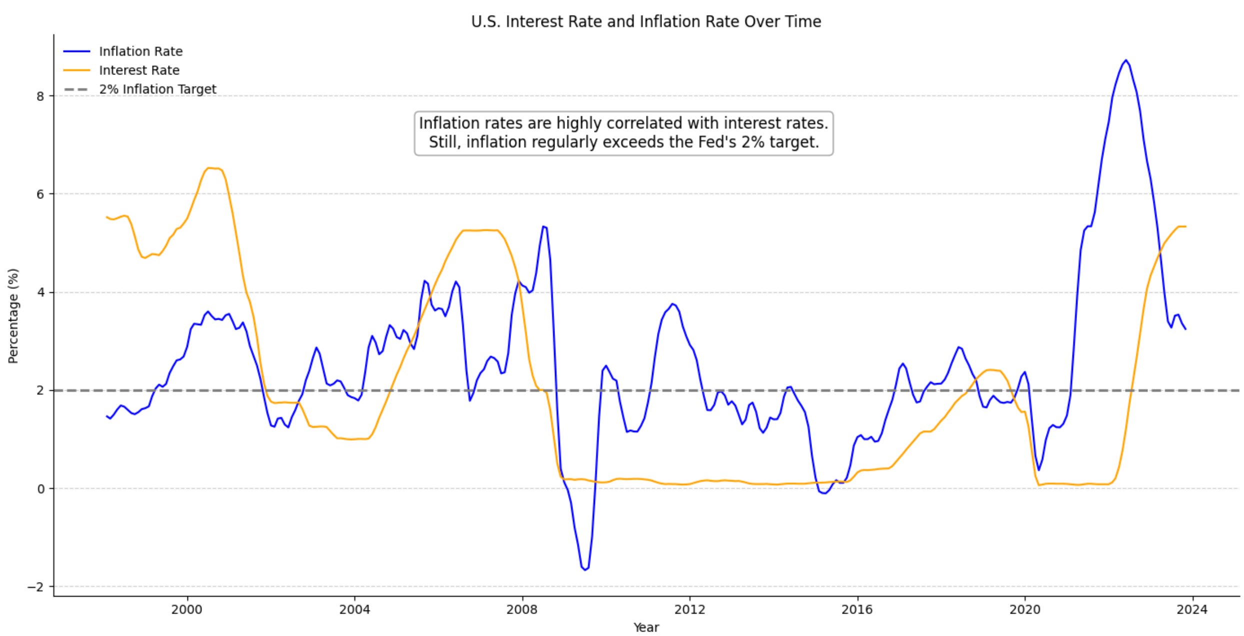
DATA 608

The Federal Reserve: An Attempt to Target Inflation and Unemployment

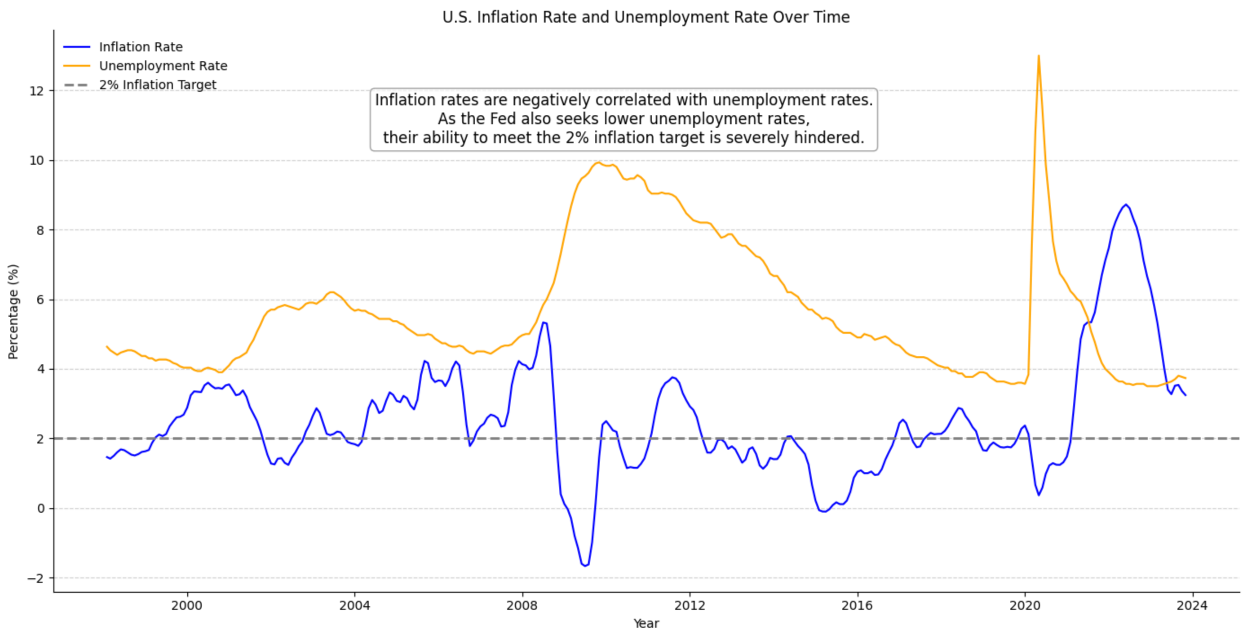
In 1977, Congress passed The Federal Reserve Act, which, among other things, highlighted the role of the Federal Reserve. The goals of the Federal Reserve, wrote Congress, include "maximum employment, stable prices, and moderate long-term interest rates." The first goal is therefore to maintain high employment rates; the latter two goals are truly one: manage inflation. As I'll demonstrate, however, the Federal Reserve is caught between a rock and a hard place as these two goals are fundamentally at odds with one another.

Let us consider first the inflation rate. The Federal Reserve aims for an inflation rate of 2%, as that is both low and stable while not being so low that it weakens the economy. There is a strong relationship between interest rates (directly in the Federal Reserve's control) and inflation rates:



As inflation rates rise, interest rates tend to rise as well. This in turn lowers the inflation rate at which point interest rates tend to fall as well. Clearly, then, the Federal Reserve indirectly has some level of control over the inflation rate as well. Why, then, is the inflation rate *ever* above the target 2% rate?

The answer lies in the Federal Reserve's dual mandate; as aforementioned, another goal is to maximize employment. Suppose the Federal Reserve raises interest rates. This makes borrowing money more expensive for companies. They may have to cut down on planned initiatives or reduce costs elsewhere. All this is conducive to layoffs and overall a higher unemployment rate. And this is the crux of the issue; while the Federal Reserve can raise interest rates to combat inflation, this is also more likely (all else being equal) to lead to higher unemployment rates.



The result is that as inflation rates rise, unemployment rates tend to fall, and vice versa. For example, the unemployment rate has been especially high over the last 25 years when the inflation rate was at or below the target 2% rate.

It is apparent that the two goals of the Federal Reserve are fundamentally at odds with one another. Perhaps the best we can hope for, then, is “low-enough” inflation coupled with “low-enough” unemployment.